from countries with tight controls on technology imports such as India, FDI has provided more ready access to advanced technologies already available through licensing to competitors from other countries.

The benefits of greater "learning" by operating in different environments and policy regimes are fairly general for all kinds of FDI. Both at home and in the host country, such learning will benefit skills as well as technology—a blurred distinction for most developing-country firms.

It would appear, therefore, that technological and skill benefits figure prominently in the home-country effects of outward FDI by developing countries. The dangers of "leakage" are even more remote than those for developed-country firms. The extent of the benefits is likely to rise with the complexity of the activity in which FDI takes place, the domestic technological capabilities of the firms concerned and the sophistication of industry and technology in the host country.

E. Industrial structure effects

The interrelationships between industrial structure, ownership advantages and FDI are well established for developed countries. Much has been written about how outward FDI is concentrated in industries marked by high levels of concentration, in turn related to high technological and marketing barriers to entry. [15] However, the impact of overseas activity on these structures has received relatively little attention, and most of this is confined to the United States.

One study investigated the effects of FDI and trade on domestic profitability in the United States, with the aim of including these factors with traditional market-structure variables (Pagoulatos and Sorensen, 1976). Price-cost margins at the industry level were regressed on a number of variables; the results suggested that greater trade competition lowered profitability, while outward FDI raised it. In other words, greater horizontal or vertical integration abroad raised domestic market power, independent of the entry barriers at home that first led to outward FDI.

The relationship between market power and foreign involvement was examined with a market-valuation approach (Hirschey, 1982), rooted in the assumption that power in foreign markets (through FDI) positively affects the domestic market value of the investor. Empirical tests showed that large United States TNCs had superior market valuations to non-TNCs, supporting the hypothesis of a positive feedback to domestic profitability. A similar conclusion was reached in another study (Cohen, 1972) with respect to the stability of domestic profitability.

The hypothesis received further support from the investigation by Fred C. Bergsten *et al.* (1978), which sought to correlate profitability in 75 United States industries from 1965-1971 with their FDI position. After controlling for other relevant variables like advertising, technological effort and size, the study established a clear, positive and statistically significant relationship between FDI and profitability. Excluding other influences, TNC earnings ranged from 5-8 percentage points above those for non-TNCs, and this relationship grew stronger over the period surveyed. The study concluded that FDI strengthens domestic market power because it enables TNCs to achieve greater vertical integration (utilizing cheap labour and/or raw materials), spread joint costs across a larger

base, diversify portfolios across different economies and markets and reduce tax liabilities (Bergsten *et al.*, 1978, pp. 234-236). "Multinational firms are twice blessed", the authors wrote. "In addition to the foreign dividends and tax credits received, the positive and statistically significant coefficient of foreign investment indicates that foreign investing raised domestic profits net of foreign dividend and tax credits" (Bergsten *et al.*, 1978, p. 245). Still, FDI carries attendant costs, risks and entry barriers—which means that not all firms or industries can reap its rewards equally.

At both the firm and the product-line level, another study found that TNCs are systematically and significantly more profitable than non-TNCs in similar activities (Benvignati, 1983). The implication is that TNCs maximize their profits globally rather than locally, and are less prone to indulge in local collusive behaviour. Thus, higher profitability appears to result from superior competitive performance, bolstered by tax advantages, rather than abuse of market power in the home country. However, such superior competitiveness may well result in the exercise of market power in smaller host-country economies.

The evidence thus supports the hypothesis that internationalization strengthens the domestic market position and profitability of firms in developed countries. Indeed, if overseas activity did not lead to higher profits than domestic activity, there would be no reason to undertake the cost and risk of FDI in the first place. Since FDI is generally associated with oligopolistic market structures built on substantial investments in technology and marketing, its contribution towards spreading the fixed costs involved and stimulating additional investments further raises the initial barriers to entry. This need not, as noted, imply anti-competitive collusive behaviour by the TNCs concerned. Nor is an inexorable rise in market concentration the inevitable result: levels would vary by industry and over time as underlying technological skill, demand and competitive conditions change.

Some of these considerations are likely to apply to developing-country FDI. To the extent that investors are large, oligopolistic firms with a domestic base of ownership advantages, the internationalization of their activities should feed back to domestic profits and market standing in the manner observed in developed countries. But whereas anti-competitive consequences in home developed countries are held in check by free access to imports and inward FDI, a strengthening of local market power may have more pronounced anti-competitive results in developing countries which place controls on imports and FDI inflows.

Since many developing-country TNCs are still "cutting their teeth" overseas, however, profitability abroad may be low in the initial period as they establish market positions (or even withdraw from some markets). This was certainly the case for several Indian TNCs (Lall, 1983, pp. 35-37). During 1980-1981, dividend remittances reached just 1.7 per cent of total capital invested overseas; the rate rises to 8.7 per cent with the inclusion of royalties and technical fees, but this is not wholly legitimate. By comparison, large firms within India paid dividends equivalent to 12.9 per cent of paid-up capital.

Indian investors fell into two distinct classes: the loss-makers, smaller on average and often poorly prepared for overseas operations; and the profit-makers, larger and presumably better prepared for internationalization. In the longer term, as TNCs mature and inefficient firms are

weeded out, profitability overseas is likely to match or exceed that at home and to feed into higher domestic profitability. This depends crucially, however, on how foreign activity strengthens domestic capabilities, exports and technology. No comparable studies are available on the profitability of large TNCs from other developing countries.

The feedback to domestic market structures is likely to be different for small, export-oriented TNCs relocating to cheaper bases overseas. As in Hong Kong, such TNCs are likely to come from fairly competitive market structures (Chen, 1983, 1984). The effect on their domestic position will depend on whether the activities remaining at home are upgraded, diversified or phased out. Some labour-intensive manufacturing may be substituted by higher-quality, more capital-intensive or design-based activity in the same field, and some may be changed into higher value-added, closely related activities. In this case, FDI will strengthen local market position, and perhaps lead to some increase in concentration. By contrast, activities that are gradually run down will simply release workers, and the industry will contract; concentration may also be increased, but purely as a defensive measure.

Anecdotal evidence on the East Asian newly industrializing economies suggests that a mixture of these reactions is possible. But in the absence of more concrete and extensive evidence, it is impossible to reach a more reliable assessment of the feedbacks from FDI in this area.

F. Government revenue effects

Two effects of outward FDI on home-country revenues must be considered. First, TNCs generally act to minimize their overall tax burdens, by taking advantage of tax concessions and by arranging financial flows and transfer prices so as to show lower profits in high-tax locations.[16] One of the major benefits of internalizing diverse markets is the broadened flexibility it provides for reducing tax exposure. To the extent that TNCs are efficient in manipulating internal markets so as to reduce tax liabilities and the home country's tax structure is relatively high, the home country suffers a loss of revenue compared to that from wholly domestic firms earning the same profit. If the home country has low or similar tax rates relative to other locations, on the other hand, TNCs may choose to declare higher profits there. The home Government may capture additional revenues by instituting stringent restrictions on intra-company transfers and uses of tax havens (as the United States Internal Revenue Service has done).

Two qualifications must be added. First, it is important to distinguish between tax avoidance through an exploitation of permissible allowances, and tax evasion through transfer-pricing manipulations. Tax avoidance is entirely legal, and any efficient firm will avoid paying unnecessary taxes; to realize more taxes, it is up to the Government to reduce allowances and close loopholes. Tax evasion is illegal, and can be countered by removing incentives (that is, by equalizing effective tax rates across countries) or by instituting appropriate checks and penalties. However, incentives arising from risk avoidance and other factors are more difficult to control. Second, even if TNCs are more "tax efficient" for their shareholders than national firms, FDI does not imply a net loss of revenue if the investment increases national income, trade or employment (all of which yield higher

revenues). The true impact on revenues must therefore be assessed along the same lines as the balance-of-payment and other effects discussed above.

The second revenue effect is more specifically related to United States tax policies on outward FDI, which has generated much controversy.[17] As noted earlier, studies by Peggy B. Musgrave (1975) and others pointed out the loss of income to the Government of the United States caused by the foreign tax-credit scheme. The present tax situation in the United States is very complex, and this volume cannot go into its details. The main lesson for developing-country exporters of capital is that tax regimes applicable to FDI should be designed with extreme care to equalize the tax burden on domestic and foreign income.[18] However, this may simply lead some TNCs to shift taxable profits to other locations, and would need to be countered by close checks. A move towards tax-rate harmonization across countries that trade and exchange FDI would be advisable.

There are no studies of these issues within the context of developing-country TNCs. Home Governments often support their firms through fiscal and other concessions when they believe these steps to be beneficial for export promotion. However, in the absence of studies on the revenue impact of such measures, it is difficult to pass any judgment.

G. Socio-political considerations

Flows of FDI can be a very effective method of linking countries economically, socially and politically. The rhetoric of "South-South cooperation" has often highlighted intra-south FDI as a vehicle to further such cooperation, to transfer economic benefits and to improve developing countries' bargaining position in the world economy.

The volume of developing-country FDI in some regions (especially the Asia-Pacific region) is reaching proportions where socio-political benefits to home countries may be significant. However, several special factors should be borne in mind. First, the "Chinese connection", which influences a large part of FDI flows in the region, existed long before capital flows began. So the causation runs from socio-ethnic factors to FDI, though FDI in turn may strengthen and shape these connections and influence related political factors. Second, the two largest investors, Hong Kong and Taiwan Province of China, face special political circumstances, both due to China. Hong Kong's main investments are in China, but the political benefits of this are not clear in view of the impending transfer of Hong Kong to Chinese control. Taiwan Province of China has used FDI as a means to win political acceptance and friends abroad, even as it has quietly invested in China without official sanction. Third, China itself is becoming a large investor—but it is not clear what, if any, political effects this may have.

To date, there is no evidence of overt use of FDI to achieve political influence or affect economic policies. Social influences are more difficult to detect, and other forces fostering cultural and social contacts are so strong that the discrete impact of FDI would be almost impossible to separate out in the Asia-Pacific region. In other regions, the volume of FDI is fairly insignificant in comparison with trade flows or FDI and aid from developed countries, and socio-political effects are likely to be very small.

H. Synthesis and conclusions

The above review of the home-country impact of outward FDI has focused largely on developed countries. The developing-country experience has not yet received proper research scrutiny, though the existing literature allows some interesting inferences to be drawn.

Many problems arise in assessing home-country effects of FDI. In a dynamic world of changing technologies, productivity, costs, skills and demand, with imperfect markets for tangible and especially intangible factors of production, it is difficult enough to attach economic values to many of the inputs and outputs utilized by TNCs. It is even more difficult in such a setting to assess plausible counterfactuals. Once firms have become transnational in a major way and have geared many domestic activities to their global operations, it is almost impossible to work out how the home economy would fare if all TNC overseas operations were to cease: the linkages with these diverse dynamic forces are simply too complex. One clear implication is that any study that purports to arrive at highly precise quantitative estimates of FDI effects must be treated with considerable caution.

The most intensively analysed aspect of outward FDI has been its effect on the balance of payments. The developed-country literature has advanced a wide range of possible effects, from a large minus to a large plus, depending on whether FDI displaces or stimulates exports and, to a lesser extent, whether it affects relative net capital formation in home and host countries. Studies of actual effects of FDI on exports suggest a mixture of displacement and promotion, with promotion the stronger influence on balance. However, such studies fail to account for the dynamics of changing competitiveness at home and abroad.

If TNCs are taken to be efficient but passive reactors to changing competitive conditions ("locational advantages" in the international investment literature), their location decisions cannot have sustained balance-of-payment effects—at most, they accelerate the ongoing shift in advantages. But since TNCs in fact serve as important agents of change in locational advantages, their decision may have a spillover effect on the process itself. By increasing their presence (through local training, research and development and other linkages) in a particular economy, they can create competitive advantages not only for themselves, but also for other enterprises. At the same time, TNCs are likely to retain strong bases in their home economies, thus providing a net balance-of-payment benefit in a structural sense.

Does developing-country FDI displace or promote exports? Evidence is extremely scarce, as no studies are available to establish what would have happened to particular exports in the alternative situation. Possibly there is some substitution, but anecdotal evidence suggests that export promotion is significant (and regarded as such by many home-country Governments). Even in countries that are clearly relocating export activities abroad, it appears that FDI—by defending export markets and facilitating domestic restructuring and upgrading—promotes competitiveness in a broad sense. The feedback of foreign activity to the generation of ownership advantages (in activities that are not completely phased out) is likely to be positive; FDI in services generally enhances foreign earnings. On balance, therefore, the balance-of-payment effects are likely to be favourable.

An evaluation of employment effects encounters difficulties very similar to those related to the balance of payments. Jobs are constantly being created and lost in a dynamic economy and, as long as total employment is satisfactory, the real cost of shifting patterns of employment rests in the adjustment process. The magnitude of this cost depends on whether affected workers can move on to higher- or lower-paying jobs, how long the transition takes, and who bears the costs of waiting, retraining and related aspects. Foreign direct investment may speed up the process of adjustment in a growing economy, or it may exacerbate the costs in an economy that fails to adapt to its loss of competitiveness. The product-life-cycle approach, which analyses such adjustments within a given firm, provides a useful framework for understanding this process.

Developing-country investors currently experiencing the fastest pace of adjustment—those from Hong Kong and Taiwan Province of China—do not appear to suffer from structural unemployment problems. They may well face adjustment problems in upgrading skills as new activities appear, but their Governments seem to regard FDI as a desirable part of the restructuring process. Their recent growth performance certainly does not suggest that FDI causes net employment or income losses—quite the contrary. For large, inward-oriented countries with FDI, the internationalization process is still too marginal to cause restructuring problems at home; to the extent that additional exports are generated, employment will benefit.

The benefits of FDI outflows are clearer with respect to domestic technology and skills. Developing-country TNCs have relatively little to fear from the "leakage" of proprietary knowledge, but much to gain from the exposure, experience and contacts that international operations provide. Firms from heavily protected economies, with inadequate access to up-to-date technologies, can benefit from foreign competition and access to new technologies, which they can feed back to parent firms. Firms from more open economies, while enjoying access to new technologies, can benefit from new learning situations or from tapping into more advanced technologies than currently available on license at home. This is particularly relevant for FDI in advanced industrial countries, or even in relatively advanced new industrializing economies. If FDI takes the form of joint ventures with developed-country TNCs and involves cooperative research and development, the benefits are further enhanced.

Similar arguments apply to skills. While FDI by a developing-country TNC in part involves transfer of skills to affiliates, certain forms of exposure can be very beneficial to the investor's own skills accumulation. This process is intensified if FDI accompanies the phase-out of low-skill activities at home and entry into new, more complex activities (the foreign affiliate can then help by financing the transition process). Some FDI, especially in services, is more directly skill-enhancing, especially when undertaken in developed countries.

It is difficult to judge the impact of FDI on domestic industrial structure. The developed-country literature suggests that TNCs enjoy stronger profitability and market positions. This may lead to increased concentration in industries where technological and marketing entry barriers are high. It may not, however, mean greater anti-competitive collusive behaviour, which is discouraged in open economies by the competitive pressures of imports and inward FDI. In developing countries, similar effects may be expected for the larger investors overseas, though they may not yet

have reached the stage of maturity when foreign operations are highly profitable. There is some risk that a strengthening of local market positions may lead to anti-competitive behaviour in countries with protectionist regimes. For smaller, more export-oriented TNCs, the effects on domestic market structures depend on whether the activity is being upgraded, diversified or phased out. In the former two cases, some concentration may result, but not so much as to hurt competition.

The revenue effects of FDI depend on two main factors—the overall income and balance-of-payment effects of FDI, with beneficial effects generally resulting in higher revenues; and the capability of TNCs to evade or avoid taxes relative to other firms. The latter will, in turn, be affected by home and host-country tax regimes, specific tax provisions for foreign investors and risk perceptions of TNCs. Some of these factors can be affected by policy, while others are more difficult to control. Evidence on the revenue effects of developing-country FDI is practically non-existent, and even general inferences are difficult to draw.

The United States experience of taxation suggests that incentives to invest abroad can result in significant revenue losses to the home treasury. Many developing countries are giving diverse incentives to their TNCs. This may be justifiable in the initial stages (to foster "infant industries"), but in the longer term should be carefully reviewed.

The socio-political feedback of outward FDI may be significant for larger developing-country investors, but at this stage it is not possible to arrive at a meaningful assessment.

In conclusion, outward FDI seems to offer net benefits to home developing countries. The extent and nature of the benefits vary by activity and country. The more open and technologically dynamic a home country, the more FDI can help in achieving structural change and upgrading. In addition, outward FDI is often (but not always) associated with inward FDI, and greater FDI in general can increase these dynamic structural benefits. Countries that are generating both new ownership and locational advantages over time, and manifesting these in FDI flows, are the most likely to achieve sustained development by participating in FDI flows. The next chapter considers some policy implications of these arguments.

Notes

1 Termed by Frankel, 1965.

2 For the succinct review, see Bergsten *et al.*, 1978, pp. 46-67.

3 For example, Stobaugh *et al.*, 1976, and Bergsten *et al.*, in 1978. In the study by Bergsten *et al.*, various company studies are cited.

4 For example, Polk, Meister, Veit, 1966, on the United States; Reddaway, 1968, on the United Kingdom.

5 Frank and Freeman, 1978, calculated export losses if domestic exports had to be made as costs rose.

6 Guimaraes, 1986. However, there is no proper evaluation given.

7 On positive effects on exports of plants from the Republic of Korea, see Koo, 1986.

8 See ibid.; on Brazil, see Guimaraes, 1986 and Villela, 1983; and on India, Lall, 1983.

9 For a review, see Bergsten *et al.*, 1978, chapter 4.

10 Based on the assumption that FDI grows at 14 per cent annually. With a 12 per cent annual growth rate, 561,000 jobs are lost, and with a 15 per cent annual growth rate, 970,000 jobs are lost, *Nihon Keizai Shimbun,* 7 December 1986, p. 3.

11 The dangers of generalizing from such a small sample, however, hardly need be stressed. Other such interview-based estimates of job gains were published by business associations (Hood and Young, 1979, p. 317).

12 Hood and Young, 1979, p. 318. However, they do not discuss what sort of adjustments are involved and also who bears the costs.

13 See Caves. 1982, pp. 220-221; Mansfield *et al.*, 1982; and Baranson, 1978.

14 See UNCTC, 1988, p.496, and Ernst and O'Connor, 1989.

15 For example, see Caves, 1982; Dunning, 1988; and Bergsten *et al.*, 1978.

16 See Caves, 1982, for a full discussion.

17 See Bergsten *et al.*, 1978, chapter 6, and Caves, 1982, chapter 8.

18 Bergsten *et al.* called this "capital export neutrality".

CHAPTER IV.

POLICY ISSUES FOR HOME COUNTRIES

A. Policies in home developing countries

As noted earlier, home developing countries of transnational corporations (TNCs) fall into two broad groups. The first consists of outward-oriented economies, represented primarily by the export-oriented newly industrializing economies. These see foreign direct investment (FDI) primarily as a means to adjust to their changing international competitive position, in one or both of two ways: by retaining the comparative advantage of their "sunset" industries through relocation to cheaper locations overseas, and by establishing beachheads in promising new markets (mainly developed countries) to take advantage of proximity to affluent customers. They also view FDI as a means to secure supplies of raw materials and, in some high-technology industries, access to new technologies.

The second group consists of inward-oriented economies, which regard FDI by domestic firms primarily as a means to preserve existing exports and promote new exports of capital and intermediate products. Some countries such as India invest largely in other developing countries; others such as Mexico invest chiefly in developed economies. Inward-oriented countries also generate a limited amount of investment in developed economies to seek new technologies and search for new markets.

While both groups view outward FDI with some favour, they adopt different policies for encouraging and regulating it. This reflects differences between the two groups in their attitudes towards foreign exchange outflows and more generally towards private sector industrial activity. Thus, export-oriented newly industrializing economies tend to have comfortable reserve positions and impose fewer controls on foreign capital accounts; they also tend to exercise lower levels of regulation on their industrial firms. The two smaller newly industrializing economies of East Asia, Hong Kong and Singapore, have long had freely convertible currencies and place no restrictions on FDI in either direction. Of the larger newly industrializing economies, Taiwan Province of China has one of the highest reserve levels in the world, and actively promotes outward FDI to help its

industrial structure to upgrade rapidly. In July 1987, Taiwanese citizens and companies were allowed to remit abroad as much as $1 million at a time, and a total of up to $5 million per year; from March 1989, they could also invest up to $5 million per year without prior authorization, and official approval of larger investments is generally routine. A liberalization of domestic securities markets in 1988, which allowed foreign financial institutions to establish branches for the purpose of conducting local brokerage, dealing and underwriting business, has given companies investing abroad access to developed-world expertise in overseas equity investment.

The Republic of Korea implemented liberalized FDI rules for domestic firms as its foreign debt position eased in the mid-1980s. Since 1989, investments up to $2 million have not required official approval. The country's Export-Import Bank gave concessionary loans for overseas investments with resources totaling 100 billion won in 1989, financing up to 80 per cent (60 per cent since February 1991) of the full investment amount (and up to 90 per cent (80 per cent since February 1991) for investments by small and medium-sized firms). Another vehicle of official assistance, the Overseas Resources Development Funds, provides the Korea Petroleum Development Corporations and the Mining Promotion Corporation with capital required for surveying and developing overseas resources. The Government offers tax incentives such as the reserve for losses incurred by FDI; investors of the Republic of Korea can reserve up to 15 per cent of the amount of outward FDI, and 20 per cent for resource-development investments. It also offers double-taxation agreements for its TNCs that subtract the amount of corporate tax paid abroad from domestic corporate tax liabilities. Where FDI is channeled into resource development, the amount of any dividend income tax paid abroad is also deducted from domestic corporate tax obligations.

An Overseas Investment Information Centre was established in 1988, primarily to aid relocation by smaller enterprises in lower-technology activities. The bulk of FDI from the Republic of Korea, however, comes from its large *chaebol*, which have a strong international presence and need little information assistance from the Government. Investors of the Republic of Korea are offered investment insurance up to 90 per cent of the total amount by the Export-Import Bank and Korea Export Insurance Company also since July 1992 to help overcome risks from political factors such as war, expropriation or restrictions on remittance.

Inward-oriented home countries tend to impose tighter controls and approval requirements on outward investors. The Government of India, for instance, until recently stipulated that all investments take the form of capital goods or know-how rather than cash, though this restriction was slightly relaxed in response to demands from Indian TNCs. In addition, the Government asked its firms to take minority positions abroad, though this requirement was waived in about a quarter of all cases (Lall, 1983). To offset the costs and risks of overseas investments, however, the Government offered various incentives such as subsidized credit, limited tax concessions and easier access to foreign exchange for travel and procurement of foreign equipment and services. For some years now, Indian firms have also enjoyed a complete tax holiday on all exports; like most developing countries, India has double-taxation agreements with a large and growing number of countries.

It does not seem that other major exporters of FDI in the developing world have adopted explicit policies to promote their TNCs, apart from the usual double-taxation agreements and

bilateral investment protection treaties (UNCTC and International Chamber of Commerce, 1992). Brazil, for example, until recently regulated FDI largely in light of its foreign exchange situation, and made little effort to stimulate FDI (Villela, 1983). The new newly industrializing economies of South-East Asia have recently adopted more liberal policies on outward FDI, again to strengthen their international competitive positions, but do not seem to have explicit policies to promote the overseas growth of their firms. It is difficult to obtain current information on this subject, however, in particular, since recent policy attention has focused primarily on the attraction of inward investment rather than on the internationalization of developing-country enterprises.

However, policies designed specifically to promote outward investment may not play more than a passive role. The driving force in FDI is the competitive position of the home economy and the openness of its trade regime. As noted for inward FDI (UNCTC, 1991b), fiscal incentives and other Government policy announcements directed at foreign investors have only a marginal effect on decisions that are essentially long-term and strategic. Long-term macroeconomic considerations, which determine the attitude of any Government to capital outflows, ideally should determine the specific policies that developing countries adopt towards FDI. This is not to argue that the regulatory environment and the availability of insurance and cheap credit do not facilitate the process of outward investment, but that the most important underlying policy influences rest in the factors considered below.

Given that outward FDI can yield significant long-term benefits to developing countries, it is important that policies in the home countries promote the right kind of investment flows and ensure that potential benefits are realized. Policy issues arise at three levels in the home country:

- to ensure that existing ownership and locational factors influencing FDI are effectively utilized, with responses guided by undistorted signals and supported to bring maximum benefit to home and host countries;
- to ensure that ownership advantages of national enterprises are promoted in the future, so that their competitive position in world markets is maintained and improved; and
- to ensure that overseas activities of TNCs provide dynamic feedbacks to the home economy over the longer term by improving the locational advantages for increasingly complex activities at home, the capabilities of local suppliers and infrastructure, the levels of skill and the efficient functioning of labour and capital markets.

The first level is concerned with the exploitation of existing advantages both in the firms concerned and in the home economy generally. The ownership advantages of firms may rest in a variety of factors, ranging from the mastery of existing technologies, efficient management or astute marketing to the possession of unique technological or managerial knowledge and skills. To ensure that these are deployed between home and foreign locations in an economically efficient way requires that the signals to which firms react are efficient (in the economic sense); that decisions are made on the basis of the best available information; that support in the form of physical infrastructure, finance, bureaucratic requirements and political backing is adequate (and at least at levels competitive with other potential investors); that taxes are as non-distortionary as feasible; and that no unnecessary obligations are imposed on investors that may hamper their overseas competitiveness.

Policies related to signals to investors have broader implications than FDI *per se*. The setting of proper price signals in product markets, for instance, is largely a matter of general trade and industrial strategy. It has been suggested earlier that export-oriented regimes provide the best environment for the development and international deployment of ownership advantages. When firms are exposed to changes in competitive conditions and technological trends, they react more quickly and efficiently than if they are protected, insulated from emerging technologies or burdened with constraints on their growth at home. While firms from protected economies do become transnational, they sometimes do so for reasons quite different from those of firms under pressure to adjust both domestic and export activities to external competition. It should be emphasized that export-oriented regimes do not necessarily imply a *laissez-faire* approach: export orientation can go together with the protection of infant industries and other selective interventions to boost competitiveness. However, such interventions tend to be designed to remedy market failures and increase the efficiency of markets; by contrast, interventions in inward-oriented regimes often are not geared to increasing market efficiency (Lall, 1991). Broad issues of trade and industrial strategy cannot be discussed here, but it is important to remember that these are relevant to FDI too.

The provision of adequate information to potential outward investors is particularly important in countries that have limited exposure to foreign conditions, and in every country to small and medium-sized firms unable to bear the costs of collecting information. Even small firms with a strong export orientation have informational handicaps because they often sell through foreign buyers, or have direct contact only with export markets in advanced countries. There is a surprising ignorance of operating conditions, costs, rules and requirements even in neighbouring countries (for example, in South-East Asia; see Whitmore *et al.*, 1989).

Part of the information function can be fulfilled by host countries, which can launch promotional programmes to attract investors. However, this is bound to be incomplete, and a rational choice of location should be based on more objective, comparative data on a range of feasible options. Many developing countries now provide this sort of information and guidance, and foreign investment promotion agencies tend to deal with both outward and inward FDI flows. It is important to increase the quality and scope of such services.

Other policies to support outward investors are self-evident. Infrastructural, financial, bureaucratic or political handicaps should be reduced as far as possible. These handicaps affect prospective investors from many developing countries and add to the costs and difficulties of international operations. They affect not only the investing firm, but also increase the costs of sourcing equipment and supplies at home and force firms to look for other (not necessarily cheaper) alternatives. In extreme cases, problems in this area can provide sufficient motivation to go abroad. The desirable way to foster FDI is to provide some locational advantages that are superior to those offered abroad, so that relocation leads to the upgrading of domestic activity.

The removal of such handicaps, however, does not mean that FDI should be subsidized relative to domestic investment. Efficient resource allocation requires that neither should be favoured. However, there are two qualifications to this general rule. First, market failures arising from lack of information, excessive risk or "infant" learning possibilities may justify an element of subsidy to

prospective outward investors. Second, where competing countries are offering subsidies, there may be a second-best argument for matching them (the optimal solution would be for all Governments to abolish excessive subsidies).

In general, a modest element of subsidy may be justified for new entrants, but this should be reduced over time. Similar considerations apply to the taxation of outward FDI. In principle, taxes should so far as possible be neutral between domestic and overseas activity and achieve a fair sharing of revenues between host and home countries. In practice, this may be difficult to achieve for newcomers to the FDI scene. Foreign activity may be far more risky than domestic activity, calling for favourable tax treatment or even tax exemption on foreign income in the initial stages. However, tax rules should be so framed that advantages accrue where they are intended—to firms rather than to foreign Governments.

Finally, the efficient exploitation of ownership and locational advantages requires that outward investors are not burdened with extra obligations that hamper their competitiveness. For instance, a Government's insistence on home sourcing of equipment or components, if these are uncompetitive in cost, quality or performance, may benefit exporters and suppliers, but detract from the longer-run survival of the foreign affiliate. These decisions should be left to the firms concerned. Firms generally would have a strong inclination to buy home-country products because of past linkages, and may help suppliers to upgrade to international standards even in the absence of special requirements.

The imposition of sweeping rules on procurement could be counterproductive. If domestic suppliers are uncompetitive, the solution is to upgrade them through capability-enhancing measures rather than to force their products on downstream firms entering foreign locations. Similar considerations apply to other aspects of foreign operations, such as equity sharing, financing, repatriation of profits and diversification. These are business decisions best left to the firms concerned rather than to Government officials or to general rules. While ensuring that firms behave as good corporate citizens wherever they operate and are sensitive to local demands, the home-country Government should interfere as little as possible in the normal conduct of business.

At the second level of policy analysis, the longer-term promotion of ownership advantages in national firms is one crucial way of maximizing the benefits of outward FDI. This raises policy issues larger than those related to FDI alone, and cannot be discussed here at length. Still, it is useful to note that the development of ownership advantages translates into the building of various types of capabilities—entrepreneurial, technological and managerial. Such accumulation is a slow, risky process that occurs within individual firms, and as a result of interaction with other firms and with the educational, science and technology and institutional structures.

The accumulation process can be simplified into three elements: incentives, which arise from the macroeconomic environment, product and factor markets and technological change; capabilities, which are determined by the education system, informal training, technological effort and formal research-and-development activity; and institutions, which set the "rules of the game", enable markets to function and support agents when markets fail (especially in technology and skill creation). It is the interaction of these three elements—healthy incentives for investment in

capability-building (as afforded by export orientation backed by infant-industry protection), capability support through education, training and research and development, and institutional development—that determines economic success (Lall, 1991).

Capability development is thus a complex process, as the constant shifting of competitive positions of developed as well as developing countries shows. It is not dependent solely on incentives, nor is it determined merely by levels of spending on education or research and development. Each element is important and the relative weight of each varies by country, its stage of development and its past strategies. But it is the complex interaction among these factors that determines the final outcome.

This volume has suggested that the strongest ownership advantages in the developing world are being generated in the newly industrializing economies of South-East Asia because of their combination of competitive incentives, interventions to promote strategic activities, heavy investments in education and technology and efficient institutional and administrative structure (Lall, 1990). There are policy lessons in their experience for the rest of the developing world.

Policies at the third level relate to the promotion of beneficial feedbacks from outward FDI to the home economy over the long term, in many ways the internal counterpart to the exploitation of new ownership advantages overseas. The dynamic process of upgrading small and medium-sized firms leads to domestic restructuring and provides the drive for foreign investments. In some cases, the same firms and activities are involved; in others, the foreign investors (and their suppliers) may be different from those who flourish in the process of economic restructuring.

The benefits from FDI can thus be maximized by promoting domestic capabilities for several purposes: to supply associated exports to TNCs; to provide new skills as old skills become obsolete or sunset activities are relocated overseas; to make labour markets flexible and responsive to changing skill needs, especially when restructuring takes place across activities; to keep industrial structures competitive and open to international trends and pressures; and to support local supply capabilities by improving the institutional and technological infrastructure. As suggested earlier, as a TNC matures, its benefits to the home economy will depend increasingly on the strength of that economy's locational advantages as a base for production, training and research and development. Inherited affinities aside, these need to be constantly boosted by capability-building policies.

As noted in the introduction to this study, in a world of intensifying competition and technological change, TNCs can serve as valuable strategic tools to help countries to retain their competitiveness and enter new activities. Developing-country TNCs can become valuable conduits of new technologies, skills and other resources to their home countries. To exploit these conduits effectively, home countries concomitantly must raise their receptive capacities, not just in activities in which TNCs currently specialize but also in those where future ownership advantages may lie.

In sum, national policies on outward FDI are largely an extension of a general development-promoting strategy. They involve the setting of competitive incentives and investments in human capital, infrastructure, technology and supporting institutions. Once these basic elements are in place, FDI can act as an engine of change and adaptation.

B. International policies

While the main thrust of FDI-related policies originates with national Governments, there are important initiatives that can be taken at the international level. International efforts in the field of FDI thus far are geared primarily to the promotion of investment flows to developing countries, rather than from them. However, international efforts can supplement policies undertaken by national Governments of developing countries to facilitate and improve outward FDI.

At the level of promoting the exploitation of existing advantages of potential developing-country investors, international initiatives can take two forms: intergovernmental cooperation, and actions by international institutions. As noted in the previous section, the facilitation of efficient FDI by developing countries requires that investors be provided with the fullest possible information on investment opportunities and conditions; adequate infrastructure, especially in transport and communications; financial support; insurance against political risks; and a smoothly functioning, neutral and supportive bureaucratic system. It also requires that the price, tax and other incentives to which investors respond in such areas as exchange rates, equity sharing rules, financial access and technology-transfer rules are as neutral and non-distortionary as possible.

International institutions can help in most of these areas. They can assist in the flow and exchange of information between developing countries, or themselves act as conduits for information on investment opportunities and conditions. There already exist international bodies to insure the political risks associated with FDI (such as the Multilateral Investment Guarantee Agency), which have accompanying promotional functions that could easily be extended to developing-country investors. Technical assistance can be of use in this context as well. [1] The establishment of efficient tax and financial policy regimes for foreign investors can be handled by a variety of international institutions that advise and/or lend to developing countries.

Apart from the established international bodies, several existing regional development institutions can facilitate information flows and dispense advice on promoting FDI flows between developing countries. For instance, Asian countries can learn much from Singapore in terms of efficient policies to attract and regulate FDI, and institutions like ESCAP or the Asian Development Bank can help with this learning process. It may be possible to set up special financial facilities for developing-country foreign investors that operate on strict commercial principles (TCMD, 1992, part III). The easing of infrastructural constraints is part of a much larger development effort in which international institutions already play a significant role, and where intergovernmental cooperation can also make a powerful contribution. An example of the latter is the establishment of a growth triangle by the Governments of Indonesia, Malaysia and Singapore—a zone that the Governments aim to develop for location of labour-intensive manufacturing industries.

For countries that are already engaged in cooperative action, as in Asia or Latin America, it is relatively easy to undertake measures to promote intra-group FDI flows, and several regional schemes have already been attempted. [2] ASEAN Industrial Joint Ventures, established in 1983 and liberalized in 1987, supports regional joint ventures in which ASEAN members hold a minimum 40 per cent combined stake, and at least two members have participations of 5 per cent or more.

The scheme offers a 90 per cent tariff reduction on joint venture products and exclusive production rights for four years. In Latin America, the Andean Multinational Enterprises programme, adopted in 1982, aims at encouraging intra-Andean FDI, in which member countries must hold a minimum 80 per cent ownership interest. The Andean Multinational Enterprises simplifies administrative procedures, eliminates sectoral restrictions and limitations on profit remittances and introduces measures to avoid double taxation.

With respect to the promotion of national competitiveness (ownership advantages), the role of international institutions is largely to support policy reforms and liberalization that lead to greater industrial efficiency. Thus, international bodies can promote directly and indirectly the adoption of more outward-looking trade strategies, more competitive and market-oriented industrial policies with a larger role for the private sector, liberalization of factor markets to reflect market conditions and accumulation of national skills and technological capabilities. It is important to note, however, that the adoption of policies to foster developing-country FDI should be integrated and consistent with policies to promote FDI more generally: one source of FDI should not be discriminated against in favour of another.

These efforts would require the strengthening of some international and regional institutions, as they would imply the assumption of new tasks and the collection of new information. However, the efforts would not be excessively expensive or demanding if the Governments concerned cooperate with international institutions and with each other. The promotion of FDI could and should be part of the larger export-promotion efforts that countries normally undertake, and that several international bodies already support directly or indirectly.

In the final analysis, the most important contribution that external assistance can make in the present context is to ensure a "level playing field" for investors from developing countries, clear rules of the game and insurance against undue non-commercial risk. Other handicaps to FDI flows may be best overcome by the expansion of trade and communications, which would create the best "image" for good companies from developing countries, inform them of each other's activities and alert them to promising investment opportunities ahead.

Notes

1 TCMD, for instance, organized a workshop to train managers from Chinese TNCs in a number of issues related to the transnationalization of their enterprises.

2 For regional schemes and their effects on FDI among developing countries, see TCMD, forthcoming.

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